



An Approach to *Writing* Loan Agreement Covenants

by Charles S. Zimmerman

This article—the first of several “evergreens” on loan covenants that will appear in the coming months—premiered 32 years ago. After an overview of the purpose, characteristics, and basic composition of loan agreements, the author discusses the use of covenants.

Loan agreements are a source of confusion and misunderstanding to many bankers.

Frequently, the reader of loan agreements is not aware of their objectives and limitations and can be bewildered by the legal jargon of the numerous qualifying clauses. Essential to the creation of effective loan agreements are the affirmative and negative covenants, which specify what the borrower must and must not do to comply with the agreement.

The Purpose of Loan Agreements

Large amounts of time, effort, and money are spent in developing and implementing loan agreements. They provide protection and communication for the parties involved and a general stability for the loan relationship through greater understanding among the parties. Further, should the borrower have other long-term debt, the loan agreement coordinates any legal or procedural interface with the debt and its associated creditors.

When several banks are participating in a large credit, the loan agreement specifies the rules that govern the loan administration and the responsibilities and liabilities of each bank.

For the lender, a major objective is to protect the loan and assure timely repayment. Through the

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loan agreement, the bank creates a clear understanding with the borrower as to what is expected. In doing so, the bank establishes its control of the relationship and provides for several basic functions to effect that control.

The lender attempts to ensure regular and frequent communication with the borrower by using certain covenants in the loan agreement. The communication results in an up-to-date assessment of the borrower's financial situation and general management philosophy.

When the bank requires that the borrower maintain certain financial ratios, it is accomplishing several objectives. On the surface, these covenants provide triggers or early-warning signals of trouble, which will allow the bank to take rapid remedial action. The borrower is made aware of where the minimum

performance cutoffs are.

However, the banker is also helping the borrower set reasonable goals in terms of financial condition and growth. In some cases, a "growth formula" is created, which states that until a specified set of financial conditions is met, the borrower may not be eligible for further debt.

All these controls—required ratios, ratio goals, required actions, and forbidden actions—may seem arbitrary or restrictive; but applied wisely, they are not. The process lets all parties know where they stand, thus reducing the number of unknowns or uncertainties in the loan relationship.

Characteristics of Loan Agreements

When asked to describe the salient characteristics of loan agreements, most bankers will use adjectives such as "long" or "dull" or "confusing." While many agreements may be so described, other definitions are certainly more informative.

The loan agreement is one of the most important loan documents in that it provides the basis for the entire banking relationship, establishing intents and stating expectations. It relates all the basic loan documents to one another and creates the means of control and lines of communication that are important in protecting all parties involved.

It follows, then, that only three main courses of action are open to the bank in the event of a default by the borrower. The account officer may waive, either temporarily or permanently, the condition that has been violated. This is frequently done in the

case of financial ratios, although too lax an attitude in this respect can lead to a loss of control and an ineffective covenant or loan agreement. An alternative is for the banker to have the agreement rewritten to make it more viable. The rewrite is also a tactic used to obtain a much tighter hold over the borrower, if needed, by using as a bargaining tool the bank's legal right to call the loan. The third, and most drastic, approach for the bank is, of course, to declare the borrower in default, call the loan, and, if necessary, file suit against the borrower.

The implications of the nature of a loan agreement are extremely important. As an example, assume that a loan has been made on an unsecured basis and one covenant forbids the pledging of assets to anyone. This is obviously an attempt to maintain the strength of the bank's unsecured position in the event of liquidation. However, let us further assume that in violation of the agreement, the borrower pledges its assets to another lender. The bank certainly retains its option to call the loan, but the other lender holds the security. If the bank does call the loan, forcing liquidation, it remains an unsecured creditor vying for those assets that remain after satisfaction of the first lien holder.

The loan agreement, then, is not a substitute for security. If a loan should be secured in the absence of an agreement, then security should be taken with one. In fact, a loan agreement is not a substitute for anything. If the situation does not satisfy the five Cs of a loan decision—char-

acter, capacity, capital, conditions, and collateral—then the loan should not be made.

Composition of a Loan Agreement

There are seven basic sections of standard loan agreements, any of which may be modified, depending upon the purpose of the loan.

The loan. This section describes the loan by type, size of commitment, interest rate, repayment schedule, and security taken, if any. Also specified are all participants and their roles, plus terms of participation if more than one lender is involved. Any definitions of financial, accounting, or legal terminology to be used in the agreement are stated here.

Representations and warranties of borrower. Basically, this section is an attestation to the lender that certain statements are true. For instance, the borrower may warrant that it is a corporation, that it is entering into the agreement legally, that financial statements supplied to the bank are true, and that no material change has occurred since their preparation. The company may attest to the nature of its business, that it does own its assets as

represented, and that it currently is not under litigation. In other words, the company reaffirms in writing all those things about its current state of existence that have been known or assumed throughout the negotiations.

Affirmative covenants. In contrast to the warranties, which attest to existing fact, affirmative covenants state what action or event the borrower must cause to occur or exist in the future.

Negative covenants. Negative covenants state what action or event the borrower must prevent from occurring or existing in the future.

Lending conditions. This section states that, prior to the lending of any money, all documents and notes must be in proper form, that both the borrower's and the bank's counsel must approve the entire arrangement, and that the borrower's auditor, or at least its chief financial officer, must certify current compliance with all conditions of the loan agreement.

Events of default. Conditions that will be considered events of default are specifically stated. Such conditions might be

delinquent payment, misrepresentation, insolvency proceedings, change in ownership, or other occurrences that could jeopardize the company's viability or the bank's position. All covenant violations are considered events of default, although many are designed to correct a situation rather than to call the loan. In any event of default, timing is crucial. For instance, it may be that default does not occur until a covenant has been violated for 30 consecutive days.

Remedies. The remedies section spells out what the bank may do in the event of default. The bank's rights may include several potential actions, but always include the right to accelerate payments, a term which means to call the loan. Timing is important. The borrower may have a certain period of time to correct the default prior to the enforcement of a remedy. In a credit with several participating banks, the remedies section also defines procedures for calling the loan. For example, the agreement may require banks representing 70% of the commitment to call the loan.



Approach to the Covenant Package

Prior to writing a set of covenants for a loan agreement, it is necessary to have a systematic approach to developing them. One must ask questions ranging from an assessment of basic objectives and risks to types of protections and remedies that must be provided to ensure the successful attainment of objectives.

Since covenants are the heart of a loan agreement, setting objectives is a process very similar to that of defining those for the total agreement. The bank is obviously hoping to be repaid on a timely basis, but it would also like to maintain or improve upon the borrower's financial position, cash flow, growth progression and general financial condition. Once goals have been set for the mutual benefit and protection of all parties, the lender must reassess the risks involved from a point of view different from that in the initial loan decision.

Determination of risk. No longer is the lender looking for a yes or no decision. The aim at this point is to define the risks and determine their magnitude. The account officer needs to ask, "What conditions or events could

block the accomplishment of my objectives?" In other words, "Where is the loan vulnerable?" Weaknesses may lie in poor cash flow, thin net worth, or other financial statement items. It may be that the industry is volatile and highly subject to strikes or public fancy. Perhaps the company is small, or it has a short track record such that much of the loan decision is based on projections.

Whatever the risks, it is now the task of the loan-agreement writer to prevent or minimize the consequences of those risks as well as possible, in a form that remains as flexible as possible.

Scope of covenants. The lender's effort to safeguard the loan against known and unknown risks will take the form of loan covenants. In terms of what triggers exist and what actions may reasonably be taken and enforced once a risk materializes, the scope of potential covenants is almost limitless. Triggers may range from financial ratios and limits on financial statement accounts to restrictions on corporate, or even management, activities.

Furthermore, methods of treating a specific item are quite flexible in order to obtain the appropriate coverage. For example, it is possible to restrict a financial statement item to a minimum or maximum of the following:

- A fixed dollar amount.
- A dollar amount increase or decrease per time period.
- A percentage of total assets, tangible net worth, or some independent indicator.
- A percentage change per time period.

As a special case, businesses subject to seasonal variances may have the above modifications fluctuate with the peaks and troughs of the cycle to more closely approximate actual conditions.

With so many potential requirements and restrictions, however, it becomes evident that the key to an effective loan agreement is not to see how many activities or conditions can be covered; it is to obtain the most protection in the simplest, most efficient manner.

Simplicity and efficiency. To devise a simple and efficient network of covenants, it is imperative for the writer to have a thorough understanding of the company, its management, and any loan-associated risk in conjunction with a realistic attitude. This combination will result in covenants that allow the borrower maximum flexibility within the constraints necessary to provide the bank maximum protection.

Effective covenants are stated in terms that are well defined and measurable. Consider the difference in ease of enforcement between the following two affirmative covenants:

1. Borrower will maintain adequate cash flow.
2. Borrower will maintain a ratio of cash flow to current maturities of long-term debt of 1.5 to 1 on a fiscal-year basis.

The necessity for a realistic attitude dictates that a covenant also be such that the borrower is able to comply with it and the lender is willing to enforce it. Should either of these conditions not be met, a covenant may be frequently waived, thereby losing

If the situation does not satisfy the five Cs of a loan decision—character, capacity, capital, conditions, and collateral—then the loan should not be made.

its psychological and perhaps legal control.

The essence of a loan agreement covenant is that it is simple, well defined, measurable, risk reducing, efficient, and reasonable. In short, it is the creative development of protection in the loan situation. As an aid to the direct application of these principles, a working guide to the construction of loan agreement covenants follows.

Working Guide for Loan Agreement Covenants

This guide, which appears as Figure 1, consists of two cross-referenced sections: functional objectives and covenants.

Functional objectives. The numbered objectives shown on the grid are more fully described in the comments that follow.

1. *Full disclosure of information.* To make competent, ongoing lending decisions, the account officer must have an intimate understanding of the borrower. Full disclosure also aids the lender in maintaining regular contact with the borrower and close control over the loan relationship.
2. *Preservation of net worth.* The borrower's basic financial strength and ability to support debt and absorb downturns lie in its net worth. The purpose of related covenants is to assure the growth and continued strength of that net worth.
3. *Maintenance of asset quality.* Asset value represents two major factors of importance to the lender: earning power and liquidation value. In either case, it is to the bank's advan-

tage to require high standards of asset quality.

4. *Maintenance of adequate cash flow.* In the case of normal repayment of a loan, the lender is repaid from the borrower's cash flow. In such cases, the lender must closely monitor the cash flow and attempt to maintain its quality.
5. *Control of growth.* As a definite drain on cash flow, working capital, fixed assets, management energies, and capital funds, excessive growth has been recognized as the cause of numerous charge-offs and bad loans in the past few years. It is obviously in the interest of both banker and borrower to maintain growth in an orderly fashion, although the two parties rarely see eye to eye on this matter. The bank's objective is to reach a clear understanding with the borrower on the limits of its growth.
6. *Control of management.* In any loan situation, but particularly if the loan is unsecured, the success of the total relationship depends heavily on the borrower's management. The bank, then, hopes to ensure the continuing quality of management.
7. *Assurance of legal existence and concept of going concern.* The purpose of devising covenants such as these is to ensure the bank of a viable entity that may produce the conditions necessary to repay its loan.

Covenants. The terms of the covenants are given in plain type in the guide, followed by an inter-

pretation of their applicability in italics.

Using the guide. The basic objectives formulated by the user for any particular agreement can be grouped into one of the eight functional objectives previously described. These are then cross-referenced to the covenants that will help achieve these objectives.

Having identified the applicable covenants, the loan-agreement writer may then apply any needed modifications and limitations.

Where a covenant satisfies a particular functional objective, an X is found in the appropriate numbered column corresponding to the applicable objective. Two examples will clarify the use of the grid:

1. To locate those covenants that apply to the functional objective "Control of Growth," search for Xs in column 5, since "Control of Growth" is the fifth objective in the grid.
2. To determine which functional objectives are satisfied by the covenant "Casualty Insurance," look at the numbered grid next to the covenant heading and then match these numbers to the corresponding functional objectives.

Where is the author now?

If you know, send an e-mail to bfoster@rmahq.org.

Have your own favorite "evergreen"?
Let us know.

Figure 1

Working Guide for Loan Agreement Covenants (cont.)

	1	2	3	4	5	6	7	8		1	2	3	4	5	6	7	8			
		X	X	X					Working capital Working capital shall never be less than \$100,000 and, in any event, at a current ratio of not less than 1.5 to 1. <i>As a strong indicator of liquidity, working capital is frequently set in different ways. Often, working capital is defined in variance with the traditional "current assets less current liabilities." For instance, prepaid expenses may be excluded from current assets, or inventory allowed at only 80% of book value. Further, the minimum working capital amount is often coupled with a minimum current ratio. The working capital required may vary according to several risk-related factors, such as growth, cyclicity, total assets, and cash flow.</i>			X							Property, plant, and equipment Property, plant, and equipment shall be maintained in good repair. <i>As with the insurance covenant, the bank is attempting to maintain the integrity of its collateral position against misuse.</i>	
		X	X		X				Net worth Tangible net worth shall never be less than \$200,000 and the rates of total debt to tangible net worth no more than 2 to 1. <i>Net worth is a measure of what would be left if all of a firm's assets were sold at book value and all liabilities paid in full. To obtain a slightly more accurate net worth figure, the bank may require the borrower to maintain a tangible net worth of a certain amount, or a ratio of debt to tangible net worth of at least a specified value. The use of tangible net worth is designed to eliminate from the ratio those assets, such as goodwill, which do not have a liquidation value.</i>		X	X	X	X			X		Inspection Persons designated by the bank shall be permitted to inspect any or all records and property to verify the authenticity of furnished statements and actual physical condition of assets. <i>As a matter of procedure, the bank should inspect the actual books and property of the borrower. The inspection is not intended to "catch" the borrower; it is merely a routine audit on the part of the bank. However, without this covenant, attempts to examine the borrower's properties could be refused or be construed as harassment.</i>	
		X	X	X					Financial ratios Generally considered to be good "triggers," there are numerous usable ratios, depending upon the desired effect. The ratios listed below appear frequently in covenants, in addition to the working capital and net worth ratios. <i>Quick ratio Times interest earned Fixed charges coverage Sales to receivables Purchases to payables Cost of goods sold to inventory Sales to assets Sales to net worth Profit to assets Profit to tangible net worth Debt to depreciated capital assets Cash flow to current maturities</i>		X	X	X	X			X			Contingent liabilities The bank is to be informed of any actual or probable litigation, or changes in contracts or the status quo, which might materially affect the business. <i>This covenant is designed to assure full disclosure of information that might affect the quality of assets or net worth, which would in turn affect the status of the loan. In closely held corporations, this covenant would also apply to the principal, including such matters as divorce settlements.</i>
		X	X	X															Banking services Principal checking accounts shall be maintained with the bank. <i>This covenant aims at gaining revenue-producing business of the borrower in addition to the actual loan. Having the accounts in-bank also allows a monitoring of the accounts and, if necessary, an offset of the account.</i>	
		X	X	X															Attorney's and printer's fees All attorney's fees and printer's fees in connection with this agreement shall be paid by the borrower. <i>Typically, the bank charges to the borrower all out-of-bank expenses associated with the loan, allowing a more certain calculation of risk versus return for the bank.</i>	

Figure 1

Working Guide for Loan Agreement Covenants (cont.)

1	2	3	4	5	6	7	8
X	X	X	X	X	X	X	
	X		X				

Change in management or ownership

Any change in management or ownership that might materially change the character or operating philosophy of the company is prohibited.

The loan is extended based on certain existing facts, among which is management. To change actual management or operating philosophy, such as expansion or product line, could be disastrous in terms of the viability of the entire company. Specific management personnel, particularly principals, may be required to stay with the borrower to prevent default.

Dividends

Dividends shall not be paid except out of net earnings accrued after the date of this agreement, and in no calendar year can they exceed 50% of net earnings after deducting all current debt service requirements.

Dividends are restricted to maintain control over cash flow and net worth. They may be disallowed or allowed in the amount of a specified percent of some measure of earnings.

1	2	3	4	5	6	7	8
	X		X				
		X			X		
	X		X				

Repurchase of stock

The borrower shall not repurchase any of its own stock.

Although it may in some cases be desirable to retire stock, generally the cash drain incurred and decrease in net worth make such purchases undesirable.

Officer salaries

Compensation for company officers in an aggregate amount shall not exceed \$150,000.

This covenant is frequently used in closely held companies where a large salary account could severely affect cash flow and net worth. Officer salaries could be set at a specific amount or be tied to a measure of profitability.

Deferred compensation

No stock option or other deferred compensation plan not in effect as of the date of this agreement shall be established.

This is one of the several covenants designed to plug any possible leaks in the cash flow cycle to avoid any diversion of cash from the operation of the business and repayment of the loan.

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